November 10, 2005

MEMORANDUM TO: Chairman Diaz

FROM: Hubert T. Bell**/RA/**
Inspector General

SUBJECT: RESULTS OF THE AUDIT OF THE UNITED STATES NUCLEAR REGULATORY COMMISSION'S FINANCIAL STATEMENTS FOR FISCAL YEARS 2005 AND 2004 (OIG-06-A-01)

The Chief Financial Officers Act of 1990, as amended, (CFO Act) requires the Inspector General (IG) or an independent external auditor, as determined by the IG, to annually audit the United States Nuclear Regulatory Commission's (NRC) financial statements in accordance with applicable standards. In compliance with this requirement, this memorandum transmits the following R. Navarro & Associates, Inc. Auditors' Reports:

- Independent Auditors' Report on the Fiscal Years 2005 and 2004 Financial Statements,
- Report on the Effectiveness of Internal Control over Financial Reporting, and
- Report on Compliance with Laws and Regulations.

Objective of a Financial Statement Audit

The objective of a financial statement audit is to determine whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation.

R. Navarro & Associates' examination was made in accordance with generally accepted auditing standards, *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. The audit included obtaining an understanding of the internal controls over financial reporting and testing and evaluating the design and operating effectiveness of the internal controls. Because of inherent limitations in any internal control, there is a risk that errors or fraud may occur and not be detected. Also, projections of

any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate. The risk of fraud is inherent to many of NRC's programs and operations.

Results of Audit

The results are as follows:

Financial Statements

- Fiscal Years 2005 and 2004 - Unqualified opinion

FY 2005 Internal Controls

- **Qualified opinion**
- Reportable Conditions:
  - Fee Billing System (Also represents a **Continuing Material Weakness**)
  - Monitoring of Accounting for Internal Use Software (Continuing Condition)
  - Information System-Wide Security Controls (New Condition)
  - Financial Controls over Disbursements (New Condition)

FY 2005 Compliance with Laws and Regulations

- Noncompliances:
  - Part 170 Hourly Rates (Continuing Noncompliance)
  - Fee Billing System - (Continuing **Substantial Noncompliance**)
  - Information System-Wide Security Controls (New **Substantial Noncompliance**)

OIG Evaluation of R. Navarro and Associates, Inc. Performance

To fulfill our responsibilities under the CFO Act and related legislation for ensuring the quality of the audit work performed, we monitored R. Navarro & Associates' audit of NRC's Fiscal Years 2005 and 2004 financial statements by:

- Reviewing their approach and planning of the audit,
- Evaluating the qualifications and independence of its auditors,
- Monitoring the progress of the audit at key points,

- Examining the workpapers related to planning and performing the audit and assessing NRC's internal control,

- Reviewing R. Navarro & Associates' audit reports to ensure compliance with *Government Auditing Standards* and OMB Bulletin No. 01-02,

- Coordinating the issuance of the audit reports, and

- Performing other procedures that we deemed necessary.

R. Navarro & Associates, Inc. is responsible for the attached auditors' reports, dated November 4, 2005, and the conclusions expressed therein. The Office of the Inspector General (OIG) is responsible for technical and administrative oversight regarding the firm's performance under the terms of the contract. Our review, as differentiated from an audit in conformance with *Government Auditing Standards*, was not intended to enable us to express, and accordingly we do not express an opinion on NRC's financial statements, the effectiveness of its internal control over financial reporting, or NRC's compliance with laws and regulations. However, our monitoring review, as described above, disclosed no instances where R. Navarro & Associates, Inc. did not comply with applicable auditing standards.

Performance Reporting

As required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

Meeting with the Chief Financial Officer

At the exit conference on November 7, 2005, representatives of the Office of the Chief Financial Officer, OIG, and R. Navarro & Associates, Inc. discussed the issues in the report.

Comments of the Chief Financial Officer

In his response, the CFO generally agreed with the auditors' recommendations. We will follow-up on the CFO's planned corrective actions during FY 2006. The full text of the CFO's response follows this report.

We appreciate NRC staff's cooperation and continued interest in improving financial management within NRC.

Attachment: As stated

cc: Commissioner McGaffigan
Commissioner Merrifield
Commissioner Jaczko
Commissioner Lyons

Chairman Nils J. Diaz
U.S. Nuclear Regulatory Commission
Washington, DC

In our audits of the U.S. Nuclear Regulatory Commission (NRC), we found:

- The balance sheets of NRC as of September 30, 2005, and 2004, and the related statements of net cost, statements of changes in net position, statements of budgetary resources, and statements of financing for the fiscal years then ended are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America;

- Except for the material weakness over the Fee Billing System, the effectiveness of internal control over financial reporting was fairly stated as of September 30, 2005, in compliance with the internal control objectives in the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. The Bulletin requires that transactions be properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and that assets be safeguarded against loss from unauthorized acquisition, use or disposal; and

- NRC continues to be non-compliant with the provisions of OMB Circular A-25, *User Charges,* for Part 170 fees. Additionally, NRC continues to have a substantial non-compliance related to the Fee Billing System and, in the current year, we are reporting an FFMIA substantial noncompliance with the security controls over applications operating at a cross-servicing agency.

The following sections outline each of these conclusions in more detail.

INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of NRC as of September 30, 2005, and 2004, and the related statements of net cost, statements of changes in net position, statements of budgetary resources, and statements of financing for the fiscal years then ended. These financial statements are the responsibility of NRC's management. Our responsibility is to express an opinion on these financial statements based on our audits.
We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing*

Standards, issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Matters of Emphasis

Classification of Costs

> OMB Circular A-136, *Financial Reporting Requirements*, provides guidance to federal agencies for presenting program costs classified by intragovernmental and public components. The basis for classification relies on the concept of who received the benefits of the costs incurred (i.e., private sector licensees versus federal licensees) rather than who was paid. However, following the advice of OMB, NRC classified the costs on the Statement of Net Cost using an underlying concept of who was paid. Furthermore, OMB Circular A-136 requires that the Statement of Net Cost be presented using full program costs by output. The agency presents its costs aggregated by strategic plan programs.

U.S. Department of Energy Expenses

> NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. For the years ended September 30, 2005, and 2004, NRC's Statements of Net Cost include approximately $68.7 and $77.2 million, respectively, of reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations applicable to NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the Government Accountability Office's (GAO) Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and should provide the results of its audits to NRC.

In our opinion, the financial statements referred to above and included in NRC's performance and accountability report present fairly, in all material respects, the financial position as of September 30, 2005, and 2004, and its net cost, changes in net position, budgetary resources, and reconciliations of net cost to budgetary resources for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

REPORT ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL

REPORTING

We have examined the effectiveness of NRC's internal control over financial reporting, as of September 30, 2005, based on the criteria in OMB Bulletin No. 01-02. The Bulletin requires management to establish internal accounting and administrative controls to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and that assets be safeguarded against loss from unauthorized acquisition, use or disposal. NRC's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants (AICPA); the standards applicable to financial statement audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 01-02. Accordingly, we obtained an understanding of the internal control over financial reporting, tested and evaluated the design and operating effectiveness of internal control, and performed such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

We identified continuing significant deficiencies in the Fee Billing System. The system in place does not meet the requirements of sound internal control over financial reporting as provided in OMB Bulletin No. 01-02, nor is the system's design compliant with the requirements of the Joint Financial Manager's Improvement Program (JFMIP - Effective December 2004, JFMIP ceased to become a standalone entity. Its functions are now under the auspices of OMB and the Chief Financial Officers' Council) for Revenue Systems. We believe such a condition represents a material weakness. A material weakness is a reportable condition that precludes the NRC's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented and detected on a timely basis.

In our opinion, except for the effect of the material weakness described in the preceding paragraph, NRC has maintained, in all material respects, effective internal control over financial reporting as of September 30, 2005, based on the internal control objectives listed in OMB Bulletin No. 01-02.

Additionally, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the AICPA and OMB Bulletin No. 01-02. A reportable condition is a matter coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment,

could adversely affect the agency's ability to meet the internal control objectives described above. We identified four reportable conditions: NRC needs to (1) improve the fee billing system, (2) improve monitoring of accounting for internal use software, (3) strengthen information system-wide security controls, and (4) strengthen financial controls over disbursements. The Fee Billing System condition is considered a material weakness.

A material weakness, as defined by the AICPA and OMB Bulletin No. 01-02, is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the principal financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe that the reportable conditions that follow, except for the Fee Billing System, are not material weaknesses as defined by the AICPA and OMB Bulletin No. 01-02.

Fee Billing System

During the assessment of internal controls in FY 2004, we identified significant deficiencies in the NRC's Fee Billing System, as described below. The agency has put forth a significant effort to address the issues reported in the prior year; however, greater emphasis and demonstrated sustainable business process improvements must be provided to remediate the material weakness.

The Omnibus Budget Reconciliation Act (OBRA-90), Public Law 101-508, as amended, requires that NRC recover, through fee billing, a percentage of its budget authority in each fiscal year, less amounts appropriated from the Nuclear Waste Fund (NWF). In FYs 2005 and 2004, the recovery percentage was 90 and 92 percent, respectively. In order to meet this requirement, the NRC assesses two types of fees to recover its budget authority. Annual fees are assessed under 10 CFR Part 171 for nuclear facilities and materials licensees, commonly known as Part 171 fees. Other fee types include license, inspection and other services, established in 10 CFR Part 170 under the authority of the Independent Offices Appropriation Act (IOAA). The Part 170 fees are assessed to recover NRC's costs of providing individually identifiable services to specific applicants and licensees.

The conditions reported in the prior year resulted from several deficiencies: (1) inadequate acceptance testing of software modifications, (2) intensive manual processes, and (3) the lack of comprehensive quality assurance procedures over the billing process. In the current year, the agency has continued to identify underbilling problems with the Fee Billing System, indicating the need to more diligently document and design internal controls for each operating aspect of the system.

The GAO's *Standards for Internal Control in the Federal Government* state, "Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations. It is performed continually and is ingrained in the agency's supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties."

The following examples provide insights into the agency's progress and current condition in addressing (1) intensive manual processes, (2) lack of comprehensive quality assurance procedures, and (3) fee billing feeder processes.

Intensive Manual Processes

Due to the age and design of the Fee Billing System, NRC has evolved over the years into an operating style characterized by over-reliance on a small team to prepare, review, and issue billings on a monthly and quarterly basis. The License Fee Team (LFT) employs various manual processes to compensate for the lack of flexibility in the legacy fee billing system. The system does not have the ability to give the agency drill down capacity to review billing questions. In particular, the system does not provide automated audit trails from the initial source of the transaction (i.e. billable hours) to the development of an invoice.

Over the last two fiscal years, the agency performed an assessment of the Fee Billing System and concluded, "...that the existing nine systems that collectively comprise the Fee Systems will not fully support fee billing and will not promote consistency across the agency. Streamlining, automating, and improving its fee systems and processes with modern and integrated technology and processes will be critical to the agency, its staff, and its customer going forward." The agency prepared a remediation plan describing actions designed to replace the existing system. Deployment of the replacement solution is planned for FY 2008.

The lack of system functionality coupled with the age of the system and its reliance on manual intervention continues to result in a Federal Financial Management Improvement Act (FFMIA) substantial non-compliance.

Lack of Comprehensive Quality Assurance Procedures

During the current year, the agency developed quality assurance procedures to reconcile the completeness of Part 170 (hourly) invoices to the license fee reports produced by the Fee Billing System. The reports provide the amounts available for billing. Late in the fiscal year, an accompanying reconciliation was performed using the new quality assurance procedures. However, the agency did not address several other reconciliation points that are essential to the internal control over fee billings.

For example, the quality assurance procedures did not address the completeness of billable contract costs as compared to contract payments made to vendors. The procedures also do not provide for a review of the reliability and completeness of data inputs from sources outside the Office of the Chief Financial Officer's (OCFO) business domain, which are integral to the reliability of invoices. Regional and technical offices such as Nuclear Materials Safety and Safeguards (NMSS) are the feeder source for license fee activities. This data is fundamental to the mapping of license fee rates in the billing preparation process. We commend the agency for its prompt action in developing some quality assurance procedures; however, much more needs to be done to mitigate

known design and system risks of the legacy system and to assert to the completeness and reliability of the fee billing process.

<u>Fee Billing Feeder Processes</u>

In the current year, the agency identified several instances of underbilling, some of which date back to FY 1991. Although the net value of these unbilled accounts receivable does not have a material impact on the Balance Sheet, these instances highlight risks that are present in the Fee Billing System. The instances identified demonstrate the need to validate the feeder data from offices outside the CFO's business domain. The issues identified impact both Part 170 (hourly) and Part 171 (annual) fee billings and were identified during tasks related to data conversion, cost accounting data analysis, and policy research, as follows:

- **Data Conversion** - The agency is undergoing a conversion of the system used by NMSS to track the licensee information by type of license. During this process, the universe of licensees was reviewed for completeness. The review identified several licensees that were inadvertently dropped from the universe of billable annual materials licensees. The information captured in this system by the program office is a key element of the data sources necessary for OCFO to identify licensees available for billing. The OCFO does not have procedures to verify the completeness of this data prior to initiating a billing cycle. The agency performed an analysis of the listing of dropped licensees and identified approximately $911 thousand of unbilled fees. The net effect on the Balance Sheet after providing for the allowance for doubtful accounts is approximately $197 thousand.

- **Cost Accounting Data Analysis** - During the third quarter billing cycle, the cost accounting team identified transactions that were assigned to suspended activity codes. Subsequently, the license fee staff researched these transactions and found that billable time (Part 170 - hourly fees) had not been billed. Program activity codes are used to capture agency costs within NRC's established budgetary program framework. The program activity codes were suspended because the general ledger tables containing viable billable codes had not been properly synchronized. At the start of each fiscal year, program activity codes are set up for all anticipated activities; however, as the year progresses new activity codes may be assigned, thereby triggering table maintenance issues. The unbilled amount was approximately $20 thousand. The agency has indicated it will develop a process to verify that all tables are properly synchronized prior to starting a billing cycle.

- **Policy Research** - During research of a policy question on billing of project managers' time (Part 170 - hourly fees), the license fee staff found that billable time assigned by NMSS managers was not included in billed amounts. Although the proper program activity codes were established at the beginning of the year, the contractor who supports the billing process was not advised of the code for

general and administrative activities. As a result, $50 thousand was not billed.

Although not material to these financial statements, the unbilled amounts illustrate the need for improved quality assurance procedures over the billing preparation process. The agency has indicated it will pursue billing and collection of each amount described in these examples.

Recommendations

1. The Chief Financial Officer (CFO) should direct an assessment of all aspects of the Fee Billing System to ensure that the remediation plan is updated as necessary and implemented in a timely manner to enhance the controls over fee billing processes.

2. The CFO should define, design, and implement compensating controls over the fee billing system, while the system is being considered for redesign.

3. As the CFO identifies needed improvement of internal controls outside OCFO's business domain, there should be coordination and collaboration with the Executive Director for Operations as to how, when and to what extent the internal controls should be strengthened in operational program feeder systems, relied upon by OCFO for billing preparation purposes.

Monitoring of Accounting for Internal Use Software

Although the OCFO has made strides with policy development and training, we continue to identify costs incurred and not recorded by OCFO for internal use software. OCFO's management control structure is designed to rely heavily on project managers to inform OCFO of time and costs expended in the software development phase. OCFO has not been fully successful in identifying projects through their monitoring procedures in order to ensure the completeness or reasonableness of the project manager's information.

Federal Accounting Standards Advisory Board issued Statements of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software,* effective October 1, 2000. SFFAS No. 10 defines three software life-cycle phases: planning, development and operations. Paragraph 16 requires, "For internally developed software, capitalized cost should include the full cost (direct and indirect cost) incurred during the development phase." The Statement defines full cost to include salaries of programmers, project managers, administrative personnel, and associated employee benefits and outside consultants' fees.

Our review of the agency's practices for accounting for internal use software projects continues to identify the following inconsistencies:

- Contractor cost incurred on projects for work performed, but for which NRC has not been billed, were not being captured and capitalized;
- Project managers, in some instances, were not coding their time appropriately during the development phase of their projects; and
- Labor certifications, in some instances, were not being completed, signed and/or were

being completed late.

For example, in the current year, our audit procedures identified several projects where the costs were not properly recorded. At September 30, 2004, several projects were capitalized at $480 thousand, however, we noted that the actual cost of the projects was in excess of $700 thousand. The OCFO did not have a business process to collect invoices from contractors involved in the development process in order to more accurately capture project costs. The June 30, 2005, quarterly financial statements reflected the correction of these asset values.

Recommendation

4. The CFO should continue to promote strengthening internal use software practices, in order to encourage project managers to comply with procedures in effect governing the completeness of new and existing development initiatives.

Information System-wide Security Controls

A recent report issued by the Office of Inspector General (OIG) (Report No. OIG-05-A-21) identified risks in the agency's information security environment. The report identifies various conditions placing the agency in an "at risk" position. The following is a partial list of the issues reported:

- A majority of the information systems (19 of 27) are under an interim authorization to operate and, therefore, are not considered certified;
- Agency information system security self-assessments were not performed timely;
- Annual contingency planning is not being performed; and
- Oversight of other contractor systems is lacking.

The OIG's report states, "NRC's general support systems have not had a complete certification and accreditation performed in the past 3 years. Therefore, the agency does not know whether the security controls for these general support systems are adequate, creating unknown potential risk. As a result, all NRC information systems that depend on the security controls provided by these general support systems inherit that unknown potential risk."

The primary agency financial reporting systems include cost accounting, human resources management system, fees and two systems outsourced with Department of Interior's National Business Center (DOI-NBC). The two outsourced systems are Federal Financial System (i.e., the general ledger application) and Federal Personnel and Payroll System (i.e., the payroll application). These systems operate or have access protocols on the NRC's general support system, which has been identified as vulnerable, since the general support system had a lapsed authorization to operate. OCFO, as the business sponsor for its systems, performed the assessment procedures necessary to adequately maintain their systems. However, their applications would be at risk since they rely on the top tier controls of the general support system.

For the systems that are outsourced to DOI-NBC, OCFO does not have processes to monitor the

adequacy of security controls maintained by the service provider. In the current year, the agency did not know that the service provider had information security issues until they were provided a reasonable assurance letter, dated October 5, 2005. DOI-NBC reported a serious weakness in complying with OMB Circular A-130, *Management of Federal Information Resources.* DOI-NBC also characterized the weakness as an FFMIA substantial non-compliance. The risks associated with (1) the lack of timely certification and accreditation, (2) delays in self-assessments, (3) the lack of annual contingency planning, and (4) the outsourced systems' substantial non-compliance, introduce an elevated risk to the NRC's information security system.

NRC management discussed these issues during the annual meeting on management controls as considerations for the agency's Federal Manager's Financial Integrity Act (FMFIA) reportable items. NRC management is reporting the security risks associated with DOI-NBC as a substantial non-compliance with FFMIA.

Recommendations

5. The CFO should coordinate with the Office of Information Services and the Executive Director for Operations to keep abreast of progress in implementing the recommendations made in the OIG's report. This awareness will enable the CFO to better plan his information system security needs.

6. The CFO should establish procedures to monitor and participate in customer advisory work groups on information security issues with the service bureau. At a minimum, the CFO should devise a communication process to stay informed about information security testing and the related results.

Financial Controls Over Disbursements

The OCFO's Division of Financial Services develops and administers policies, standards, and procedures for all financial operation activities of the NRC. The Division is comprised of teams which devote their full attention to time and payroll processing, development of payment policy, processing of obligations, authorizing the payment of non-payroll transactions, and managing approximately 60 percent of the agency's budget through the Central Allowance Team.

The GAO's *Standards for Internal Control in the Federal Government*, state "Internal control should generally be designed to assure that ongoing monitoring occurs in the normal course of operations. . . . It includes regular management and supervisory activities, comparisons, reconciliations, and other actions people take in performing their duties." The Standards also state, "Management's philosophy and operating style also affect the environment. This fact determines the degree of risk the agency is willing to take and management's philosophy toward performance-based management. Further the attitude and philosophy of management toward information systems, accounting, personnel functions, monitoring, and audits and evaluations can have a profound effect on the internal control."

In the current year, we found that the agency made one improper payment in excess of $1

million. The NRC became aware of the error because the rightful vendor who was not initially paid, contacted the agency to inquire about the status of its payment. An error of this nature could have been prevented by the controls described below:

- The agency has controls to verify the existence of vendors prior to payment. However, the agency does not have verification controls to review the propriety of edits made to the vendor tables. In the present case, two vendors requested changes to their vendor profiles. Items such as vendor name, address, tax identification number and bank routing numbers are maintained in the vendor profiles.

- In the prior year, the agency indicated that it was adopting OMB's guidelines for drawing on the Central Contractor Registration (CCR) information to verify electronic funds transfer (EFT) information. The agency's system was planned to verify the propriety of payment information between the NRC's vendor tables and the CCR database prior to payment. We understand that the CCR business rules were implemented relying on internal NRC vendor table maintenance controls, rather than CCR validations. NRC has not implemented the secondary review of vendor table changes.

- The agency does not have controls in place for review and approval of high value payments to non-federal entities. NRC's high value payments range from amounts in excess of $250 thousand to $300 thousand. Payments in the high value category are not reviewed any differently than payments of nominal value. An independent or secondary validation of these amounts would most likely have detected the payment error.

Additional concerns with this improper payment are (1) the OCFO's lack of disclosure and (2) the lack of understanding of the impact of interest owed on the late invoice to the liabilities included on the Balance Sheet. This condition imposes unnecessary risk in the control environment.

Recommendations

7. The CFO should direct an assessment of financial controls over disbursement activities. At a minimum, the assessment should provide for the development and implementation of second party reviews of the propriety and accuracy of edits to vendor tables.

8. The CFO should periodically assess whether CCR data can be used to provide an electronic validation of EFT information against NRC's payment system prior to certifying the payment.

9. The CFO should establish a secondary review of high value payments. The secondary review should be performed by parties that are not involved directly in payment processing.

10. The CFO should reiterate to all agency managers the importance of having full and open discussion about internal control impacting the reliability and completeness of the agency's financial statements. This discussion could be incorporated during the

upcoming implementation of OMB Circular A-123.

Status of Prior Year Comments

In the prior year, we included conditions related to User Organization Compensating Controls and Inadequate Acceptance Testing (included in the Fee Billing System condition) in our report. Corrective actions were implemented during the year to close these two conditions. However, conditions related to the fee billing system, and monitoring of accounting for internal use software continued in the current fiscal year.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We conducted our audit for the year ended September 30, 2005, in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02.

NRC management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of applicable regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements in the FFMIA. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to NRC. The results of our tests of compliance disclosed noncompliances with laws and regulations that are required to be reported under *Government Auditing Standards,* OMB Bulletin No. 01-02 or under FFMIA.

U.S. Department of Energy Expenses

> NRC's principal statements include reimbursable expenses of the U.S. Department of Energy (DOE) National Laboratories. For the years ended September 30, 2005, and 2004, NRC's Statements of Net Cost include approximately $68.7 and $77.2 million, respectively, of reimbursed expenses. Our audits included testing these expenses for compliance with laws and regulations applicable to NRC. The work placed with DOE is under the auspices of a Memorandum of Understanding between NRC and DOE. The examination of DOE National Laboratories for compliance with laws and regulations is DOE's responsibility. This responsibility was further clarified by a memorandum of the GAO's Assistant General Counsel, dated March 6, 1995, where he opined that "...DOE's inability to assure that its contractors' costs [National Laboratories] are legal and proper...does not compel a conclusion that NRC has failed to comply with laws and regulations." DOE also has the cognizant responsibility to assure audit resolution and should provide the results of its audits to NRC.

The objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions of laws and regulations and, accordingly, we do not express

such an opinion.

Our report contains three noncompliances. There is one noncompliance with OMB Circular A-25, relating to the development of Part 170 hourly rates, which was initially reported in 1998. The other two items are substantial noncompliances with FFMIA. The Fee Billing System condition reported in FY 2004 continues to exist. In the current year, there is an information system security substantial noncompliance related to the Department of Interior's cross-servicing of the agency's general ledger and payroll service applications. The following discussion addresses the noncompliances:

Part 170 Hourly Rates

As previously reported from FYs 1998 through 2004, the Omnibus Budget Reconciliation Act (OBRA) of 1990 requires the NRC to recover approximately 100 percent of its budget authority by assessing fees. (In recent years, the recovery percentage has been reduced by 2 percent each year. During FY 2005, the recovery percentage was 90 percent.) Accordingly, NRC assesses two types of fees to its licensees and applicants. One type, specified in 10 CFR Part 171, consists of annual fees assessed to power reactors, materials and other licensees. The other type, specified in 10 CFR Part 170 and authorized by the Independent Offices Appropriation Act of 1952, is assessed for specific licensing actions, inspections and other services provided to NRC's licensees and applicants.

Each year, the OCFO computes the hourly rates used to charge for Part 170 services. Consistent with OBRA of 1990, the rates are based on budgetary data and are used to price individually identifiable Part 170 services. NRC developed the FY 1998 and subsequent years' rates using the budgetary basis without validating the fee amounts to the full cost of providing Part 170 services.

During FYs 2004 and 2005, the agency continued to make progress and is presently refining a strategy to address this noncompliance. At year-end, the CFO initiated a dialogue with us on their strategy. Initially, the agency was pursuing the development of a validation model to compare budget vs cost-based fee calculations. More recently, the agency has devised a proposed cost-based calculation strategy to develop rates in compliance with OMB Circular A-25, *User Charges.* Once the OCFO completes the implementation of this proposed calculation strategy, we will review the resulting calculations or model and the underlying documented assumptions and data sources used in order to verify the reliability and completeness of the results. The audit assessment will also evaluate the adequacy of fee rule changes, if any. We commend the CFO for their continuing efforts to close this comment.

Recommendation

11. The CFO should continue to pursue the proposed calculation strategy and develop rates in compliance with OMB Circular A-25. OCFO management should inform the Office of Inspector General of the progress and actions taken to correct this condition.

Fee Billing System

In our *Report on the Effectiveness of Internal Control Over Financial Reporting,* we identified Fee Billing System as both a material weakness and an FFMIA substantial noncompliance. Refer to that report for a detailed discussion of the condition.

Information System-wide Security Controls

In our *Report on the Effectiveness of Internal Control Over Financial Reporting,* we identified the information system-wide security controls as an FFMIA substantial noncompliance. Refer to that report for a detailed discussion of the condition.

Status of Prior Year Comments

In the prior year, we included a condition related to Fee Recovery From Licensees in our report. Corrective actions were implemented during the year to close this condition. However, the condition related to Part 170 fees and the FFMIA substantial noncompliance of the Fee Billing System continued in the current fiscal year.

INTERNAL CONTROL RELATED TO PERFORMANCE MEASURES

With respect to internal controls related to performance measures described in Chapter 2 of the Performance and Accountability Report, the OIG performed those procedures and will address this issue separately. Our procedures were not designed to provide assurance over reported performance measures and, accordingly, we do not provide an opinion on such information.

CONSISTENCY OF OTHER INFORMATION

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information included on pages ---- to ----, and the Management Discussion and Analysis, Chapter 1 of this Performance and Accountability Report, is not a required part of the financial statements but is supplementary information required by OMB Circular A-136. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

The other accompanying information included in Chapter 2 and the appendices to the Performance and Accountability Report, are required by OMB Circular A-136 and are presented for purposes of additional analysis and are not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements of NRC taken as a whole. The required supplementary information, Schedule of Intragovernmental Assets and Liabilities and the Schedule of Budgetary Resources, included on page **xxx** of this Performance and Accountability Report, is not a required part of the financial statements but is supplementary information required by OMB Circular A-136. This information is also presented

for purposes of additional analysis of the financial statements rather than to present the budgetary resources of NRC programs. This information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

This report in intended solely for the information and use of NRC management, the Inspector General, OMB, GAO, and the Congress and is not intended to be and should not be used by anyone other than these specified parties.

November 4, 2005